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C O N F I D E N T I A L SECTION 01 OF 03 ANKARA 003412

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TREASURY FOR OASIA - RADKINS AND MMILLS
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TAGS: EFIN ECON EAID PREL PGOV TU
SUBJECT: POST THOUGHTS ON WORLD BANK LOAN

REF: A. ANKARA 3257

¶B. ANKARA 3131

Classified By: Deputy Chief of Mission Robert Deutsch for reasons 1.4 (b) and (d).

¶1. (C) Summary: The first tranche of the PFPSAL3 loan going to the World Bank board June 17 overlaps substantially with the IMF program on fiscal and banking issues and, in several areas, is justified on the basis of the GOT's renewed engagement with the Bank and agreements on actions to be taken, rather than on tangible results. On the other hand, the GOT genuinely seems to have re-engaged with the Bank, and seems to be preparing several key reforms. Some of the weakest areas of structural reform--privatization, telecoms and energy--are not under the umbrella of this particular loan. Post recommends the USED raise concerns about the need for tangible results in a number of areas to ensure that the Bank programs accomplish their objectives. Given the late timing, it may make more sense to engage with the Bank to stiffen conditionality for the second tranche than to abstain now. End Summary.

¶2. (Sbu) On June 17, the World Bank board is scheduled to consider the first $500 million tranche of the World Bank's PFPSAL3 (Third Programmatic Financial and Public Sector Adjustment loan), post offers some comments and the loan and the state of play between the Bank and the GOT. The loan represents the biggest chunk of a surge of renewed Bank lending since the GOT re-engaged with the Bank at the beginning of 2004, after over a year of very limited cooperation. According to Country Director Andrew Vorkink, the disbursement would bring total Bank lending for this year (the Bank's June 30, 2003 to June 30 2004 fiscal year) up to $1.6 billion, all since January.

¶3. (Sbu) The loan, which picks up where the stalled PFPSAL2 left off, is an umbrella for a series of disparate reforms in the financial and agricultural sectors and in public administration and fiscal policy. Some of the key areas are the state bank privatization process, bank regulatory issues including a new banking law, continued implementation of agricultural sector reforms, reducing public sector employment, public procurement, reform of the tax administration and other public sector reform issues. World Bank Financial Economist Rodrigo Chavez said that the loan takes PFPSAL2 conditions, resurrects them and adds more conditionality. For example, on bank regulation, the earlier loan required a series of ad hoc measures, but the new loan requires the banking law to take broader measures such as tightening the "fit and proper" criteria for bank ownership.

Overlap with IMF:

¶4. (Sbu) If the issues sound familiar, it's because many of them have also been requirements of the IMF program. During the period of GOT unwillingness to implement many Bank-sponsored reforms, the IMF, with its greater leverage, picked up a number of issues on which the Bank had the greater expertise or the lead. During this period, the IMF adoption of Bank conditionality helped move the reforms forward. This was notably the case on state bank privatization and the Public Financial Management and Control Law (PFMC), passed at the end of 2003. In addition to significant overlap with the IMF, the Bank loan document seems to rehash and treat as current reforms actions that were taken in conjunction with IMF reviews in 2003 and early ¶2004. Examples of this are the discussion of the PFMC, the public sector employment reduction, the direct tax reform, budgetary classification reforms, and the public procurement reforms (aside from recent amendments to the procurement law to allow the Privatization Authority to tender for a financial advisor, which is of recent vintage).

The Proof is in the Pudding:

¶5. (Sbu) On several key issues, both in the measures covered

by this loan and in other areas, such as energy, the Bank faces a dilemma. On the one hand, after the hiatus in cooperation, Bank staff are pleased that the GOT is seriously consulting with them and negotiating strategies to moved stalled sectoral reforms forward. Consequently, the Bank conditionality often is framed in terms of agreement on a strategy (state bank privatization and energy) rather than tangible results such as actual privatization. On the other hand, while some of these issues are both politically and technically difficult, such that it would be unrealistic to require immediate results, given the GOT's unimpressive record on structural reforms, there is a danger of disbursing before the hard steps are taken.

¶6. (C) Perhaps the best example of this, and a central issue in the loan, is state bank privatization. Given the failure of the Bank's last attempt on this issue, the Bank is understandably pleased to have revived the process, with apparent buy-in, at least by Turkish Treasury. Bank Economist Rodrigo Chavez argued to econoff that there is no way Ziraat or Halk Bank could be privatized soon, since these banks are laden with non-marketable government securities. He said that Ziraat, for example, has $1.5 billion in normal banking assets and $25 billion in these non-marketable government securities. Note: Other post contacts, including Turkish Treasury's domestic debt managers, are unanimous on this point. Most private bankers tell econoffs Ziraat and Halk would elicit zero interest from potential buyers. End Note. The PFPSAL3's second tranche, due to be disbursed by yearend 2004, will require further action on the state bank privatization process, such as Council of Ministers approval of a strategy and a substantial (Chavez mentioned $5 billion) removal of capital from the State Banks. Chavez said that Minister Babacan had recently told the World Bank he wants to accelerate its programs. Chavez said Bank disbursements in 2005, for a follow-on Bank facility to deepen reforms in the financial sector, would require the privatizations of Halk and Ziraat to go through by June and December 2005 respectively.

¶7. (Sbu) Likewise, a key provision of the loan (and of the IMF program) is the passage of a new banking law. Here, too, the timing has slipped, and the GOT no longer expects passage of the law before the summer parliamentary recess. Chavez argued that this is acceptable for two reasons. First, very detailed World Bank requirements are spelled out in the program document, including tightening of fit and proper criteria for bank ownership and spelling out the details of cooperation between the newly-split bank regulatory agency (BRSA) and deposit guarantee fund (SDIF). So, the conditionality is there, according to Chavez, even if the law is not yet passed. He also pointed out that, after extensive consultation with bankers, and the complexity of the issues, there may need to be a period of reflection. He said the Bankers Association recently came in with 46 pages of comments on the draft law.

¶8. (Sbu) Another key World Bank (and IMF) reform in which legislation has not yet been passed is the reform of the tax administration. On this issue, however, unlike state bank privatization, or the independence of regulatory boards, post is more confident of GOT ownership and commitment. U.S. Treasury tax technical advisors have been impressed with the level of buy-in from the Ministry of Finance, up through the Minister. Washington agencies may wish to consult with the U.S. advisors on their views of the tax administration reform, which they are helping the GOT to implement.

The Value of Deterrence:

¶9. (C) One way in which the PFPSAL3 and the Bank's newfound willingness to disburse play a very constructive role is as a deterrent against anti-reform backsliding on the part of the GOT. Though the PFPSAL3 talks about strengthening the independent regulatory boards, in fact, post understands from BRSA Chairman Tevfik Bilgin, Capital Markets Board Chairman Dogan Cansizlar and Vorkink and Chavez, that the GOT was on the verge of blessing legislation that would have undermined--rather than strengthened--their independence. By all accounts, the Bank and the Fund played a key role in stopping the GOT from this anti-reform measure.

Are "High Case" Disbursements Justified?

¶9. (Sbu) With the recent surge of Bank disbursement, Vorkink said the Bank would be on-track with the "High Case" disbursement scenario, which assumed strong GOT implementation of the reform program. Post understands some in the USG may be uncomfortable with the Bank disbursing at this level, at the same time we are unhappy with the slow pace of progress in areas such as energy and telecoms sector liberalization and, especially, privatization. Unfortunately, the PFPSAL3 provides an awkward vehicle to register these USG concerns because the slow-moving

reforms--with the exception of state bank privatization--are under other Bank facilities, not the PFPSAL3.

Ag Policies:

¶10. (Sbu) The World Bank deserves credit for its success in moving the GOT over the years to support agriculture through direct income supports rather than other, more market-distorting measures. However, post understands that many farmers have not received their support payments, and we have other concerns about agricultural policy which are apparently tolerated by the World Bank. For example, Turkey has some of the highest maize prices in the world ($190/ton in the U.S. versus $350/ton in Turkey). The GOT has raised import duties during the harvests in recent years to bolster farmgate prices and in January 2004 raised tariffs to 80%. The high corn prices have caused a crisis in the poultry industry that is currently selling poultry domestically below its production costs. The PFPSAL3 document mentions the introduction of a maize deficiency payment. Post believes such a payment would only encourage the Turkish Grain Board (TMO) to purchase addditional domestic corn at high prices, thus circumventing the Turkish private sector. A better way to encourage increased corn acreage would be to reduce incentives for overproduction of other crops. The PFPSAL3 document also mentions investment subsidies for the troubled livestock sector. Post notes that beef prices in Turkey are higher than in Switzerland, and that Turkish authorities often refuse to appprove health certificates for any meat or poultry products. With these protections, some of Turkey's major conglomerates are investing in this sector. Investment subsidies seem ill-advised in this situation.

Conclusion:

¶11. (Sbu) Post recommends the USG use the opportunity provided by the board vote to point out the contradiction between the high case level of disbursement and the slow progress on privatization, energy and telecoms sector reforms. Having been a strong advocate of structural reforms, post welcomes enhanced World Bank engagement in recent months, but the Bank needs to play its usual role of insisting on meaningful reform that accomplishes the objectives of the program. The problem in this case appears to lie more with the Bank's soft conditionality than with the GOT's failure to implement it. Given that we seem to be engaging with Bank staff on this at a late stage in the process, it might make more sense for the U.S. not to abstain on the first tranche, but insist on more meaningful progress before disbursement of the second tranche, based on the fact that Turkey's implementation of structural reforms is essential to sustain the momentum generated by the macro reforms of the past three years.

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